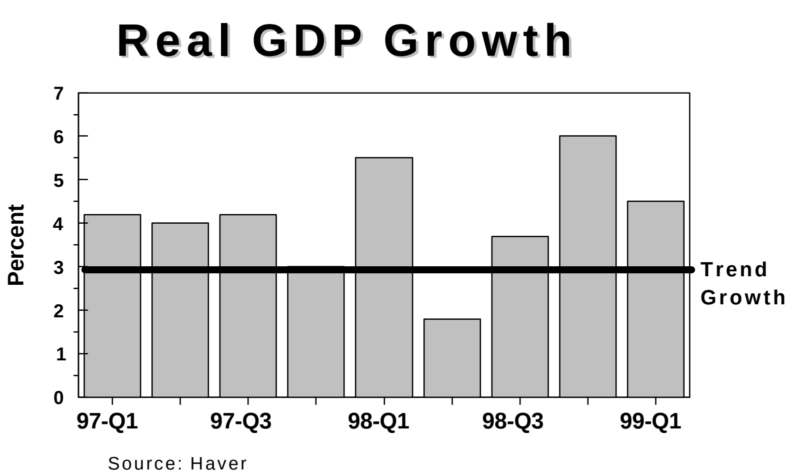
ECONOMIC BULLETIN **June 1999**

Editor's Note: *This is the first in a series of monthly economic updates which will supplement the weekly Budget Bulletin. The first section reviews recent economic developments, while the second section focuses on a selected issue.*

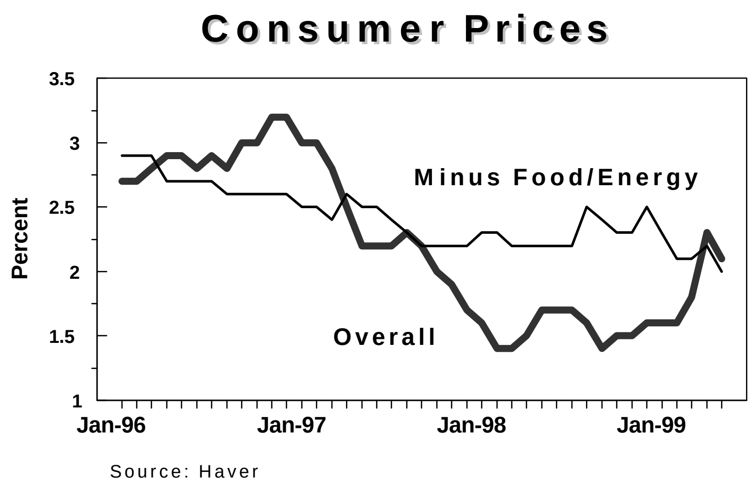
Global Stability, a Negative for the US Economy?

The US economy continues to surge, with Blue Chip now expecting 3.9 percent real GDP growth in 1999 and 2.5 percent growth in 2000. Perversely, much of the current strength is due to the global financial crisis -- slowing global demand led to lower US interest rates, which ignited the interest rate sensitive sectors of the US economy. However, this suggests that signs of renewed global stability carries risks for the US economic outlook.



It is hard to avoid the conclusion that the US economy is overheating at present despite substantial gains in productivity. CBO believes that the economy's sustainable trend real growth rate is roughly 3 percent. (This estimate has been raised sharply in recent years in light of the rapid expansion of the US capital stock and technical CPI changes). Nonetheless, real GDP growth has topped this pace in all but one quarter since early 1997.

However, if the economy is overheating, why hasn't there been more of a buildup in inflationary pressures since 1997? The global financial crisis has played a large role. It led to a reduction in world growth, a plunge in commodity prices and a sharp appreciation of the US dollar, which provided strong external restraints on US inflationary pressures. However, these factors are unlikely to persist if the global financial crisis has ended as many believe.



Indeed, some commodity prices have already begun to rise -- oil topped $17/barrel recently, causing a sharp jump in the April Consumer Price Index. This jump was not surprising, since much of last year's decline in inflation stemmed from the volatile food and energy sectors. (While May's CPI report was more subdued, the year over year growth in overall CPI remains elevated relative to last year.)

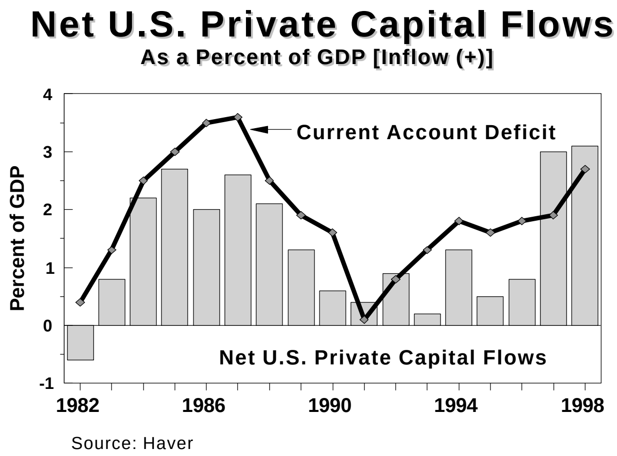
The dollar has also stopped appreciating -- the Atlanta Fed's dollar index topped in August 1998. When combined with the spike in oil prices, import costs have risen in four out of the first five months of 1999, after having fallen for almost all of 1997 and 1998.

The prospective lifting of inflation restraints is already worrying financial markets. The 30-year Treasury bond yield has soared from 5.1 percent at the start of 1999 to 6.0 percent presently. (A prospective reversal of recent "safe haven" flows is also a negative for bonds, as noted in the next section.) The rise in inflation expectations is a large reason why many economists expect the Federal Reserve to raise interest rates by 25 basis points at their next meeting on June 29 and 30th.

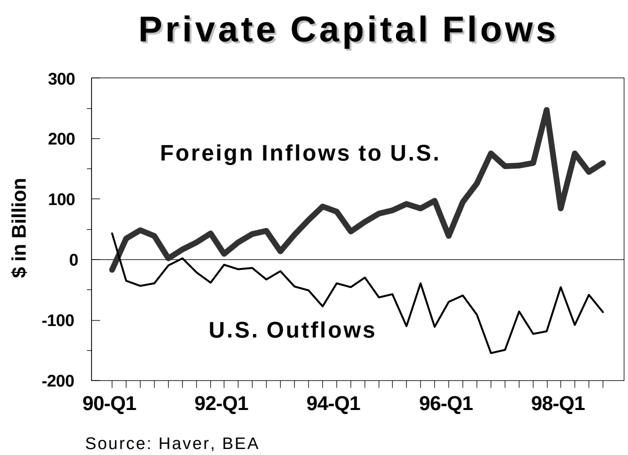
Since low long-term interest rates have been the lifeblood of recent economic growth, any sustained back-up in yields could have an adverse effect on the US economy over the next year. Looking further ahead, high interest rates could also curtail the investment that has underpinned recent productivity growth. Thus, paradoxically, the US economy may have more to fear from global stability on net, than from global crisis.

Selected Issue: The Global Financial Crisis' Impact on US Capital Flows

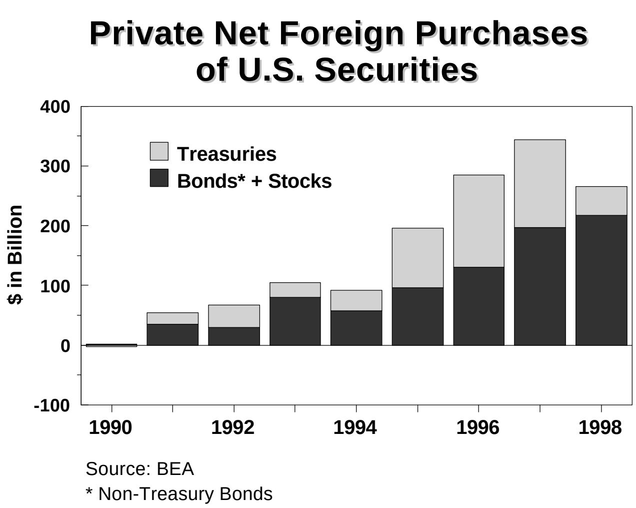
The global crisis played a large role in reducing US long-term interest rates in 1997 and 1998. In addition to lowering US inflationary pressures, the global crisis unleashed large so-called "safe haven" flows into US assets, as investors sought to pull their money out of crumbling emerging markets and to park them in the safety of the US. This contributed to a dramatic appreciation in US asset prices last year and a reduction in US long-term interest rates. Yet, when investors regain confidence in emerging nations, these flows are likely to reverse, which could put continued upward pressure on US interest rates.



Let's put the size of these "safe-haven" flows into perspective. The first chart shows how net private capital flows into the US have evolved since 1982 as a share of GDP. (The US has been in persistent trade/current account deficit during this period, so one would expect to have net capital <u>in</u>flows in order to finance this deficit.) One would also expect such inflows to rise as the trade/current account deficit grows. Yet, these inflows exceeded the current account deficit in 1997 and 1998, bespeaking very strong demand for US assets during the crisis.



What drove this surge in net private capital inflows? Part of it reflects increased foreign investment in US assets, and part reflects the fact that Americans scaled back their acquisition of overseas investments, as the accompanying chart shows.



Let's look first at the foreign side of the equation. Foreigners sharply increased their purchases of US assets in 1997, as they attempted to flee the turmoil of emerging markets. Initially, they flooded into Treasuries and US bank deposits. Yet by 1998, they scaled back these purchases notably, since they needed to keep more of their funds at home to shore up their balance sheets. (Foreign-based hedge funds were also forced to raise cash to cover margin calls). Despite this overall scale-back in 1998, foreigners remained voracious buyers of US equities and corporate bonds (which offered a higher yield than Treasuries). **Foreign purchases of US stocks rose six fold in 1997 and stayed strong in 1998 as well**.

Now let's look at the US side. US investors continued to place money abroad at a fast pace during 1997. However, this disguises some interesting trends. By the end of 1997, Americans had sharply reduced their purchases of foreign securities. Banks and nonbanks initially filled the void, by stepping up their loans to foreigners as the turmoil first hit. However, by 1998, banks tightened their credit standards and decreased their new loan extensions, generating a notable decline in overall US capital flows abroad in 1998.

Both the influx of foreign money and the lessened outflow of US funds led to lower interest rates in the US, as the increased demand for US assets drove bond yields lower.

What will happen as the global financial crisis recedes? It seems logical that foreign desire for US assets may ebb somewhat, while US investors step up their foreign purchases. The latter scenario could be motivated by a search for higher yields and a desire to increase portfolio diversification. Due to the plunge in the value of emerging nations' currencies and asset markets in 1998, holdings of international securities have declined as a share of overall US assets -- only 5 percent of mutual fund assets are invested abroad today, down from 16 percent in 1996.

Of course, it will take time for US investors to regain confidence in emerging nations. Yet, when this occurs, it should lead to upward pressure on US interest rates, all other things equal, as less money chases US assets. Unfortunately, this could come at a time when the economy is already faced with a post-crisis rise in commodity & import prices and a weakening of stock valuations.

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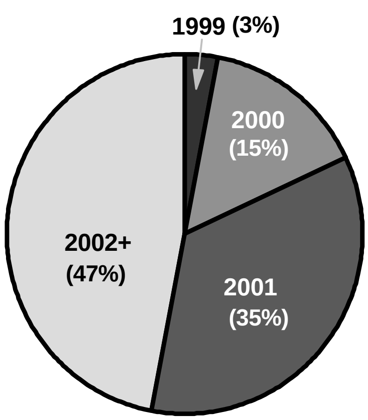
In April, Blue Chip asked its economists when they thought the next recession would begin. They were quite optimistic — nearly half did not expect one until 2002 or beyond.



(Note, however, that this survey was done before the recent flare-up of inflation fears and rise in bond yields).

Main US Economic Indicators

	Q3-98	Q4-98	Q1-99	Most Recent
Real GDP Growth	3.7	6.0	4.1	
Consumption	4.1	5.1	6.8	
Business Investment	-1.0	17.8	9.7	
Unemployment Rate	4.5	4.4	4.3	4.2(May)
Productivity Growth	2.7	4.6	3.4	
CPI Inflation	1.6	1.6	1.7	2.1(May)
30 Year Treasury Yield	5.1	5.2	5.6	6.0(June)
Dow	7850	9180	9790	10700(June)